



**Operator:** Greetings and welcome to the Sun Hydraulics Corporation First Quarter 2018 Financial Results conference call. At this time, all participants are in a listen-only mode. A question-and-answer session will follow the formal presentation. If anyone should require Operator assistance during the conference call, please press star, zero on your telephone keypad. As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Karen Howard, Investor Relations for Sun Hydraulics. Please proceed.

**Karen Howard:** Thank you, Myrtle, and good morning, everyone. We certainly appreciate your time today for our First Quarter 2018 Financial Results conference call. On the line with me are Wolfgang Dangel, our President and Chief Executive Officer, and Tricia Fulton, our Chief Financial Officer. Wolfgang and Tricia will be reviewing the results that were published in the press release distributed after yesterday's market close. If you do not have that release, it's available on our website at [www.sunhydraulics.com](http://www.sunhydraulics.com). You'll also find slides there that will accompany our discussions today.

If you'll look through the slide deck, on Slide 2, you'll find our safe harbor statement. As you may be aware, we will make some forward-looking statements during this presentation and also during the Q&A. These statements apply to future events that are subject to risks and uncertainties as well as other factors that could cause actual results to differ materially from where we are today. These risks and uncertainties and other factors are provided in the earnings release as well as other documents filed by the Company with the Securities and Exchange Commission. These documents can be found at our website or at [www.sec.gov](http://www.sec.gov).

I also want to point out that, during today's call, we will discuss some non-GAAP financial measures, which we believe are useful in evaluating our performance. You should not consider the presentation of this additional information in isolation or as a substitute for results prepared in accordance with GAAP. We have provided reconciliations of comparable GAAP and non-GAAP measures in the tables that accompany today's earnings release as well as in the slides.

Wolfgang will get started with some highlights for the quarter. Tricia will go through the details of our financial results. And then, we'll turn it back to Wolfgang for his perspective on our outlook before we open up the line for questions and answers. With that, it's now my pleasure to introduce Wolfgang.

**Wolfgang H. Dangel:** Thank you, Karen. Good morning, everyone. Please turn to Slide 3.

We are off to a solid start in 2018. Driven by very strong demand, our first quarter results were generally in line with our internal expectations, although our Hydraulics segment was challenged operationally due to supply chain constraints. Given some actions we've taken, we are already seeing margin improvement thus far in the second quarter. In addition to reporting solid financial results, even more importantly, we continue to make significant progress on our Vision 2025. I'll get more into that in a moment.

Let me start with highlighting the financial results for the quarter. And then, Tricia will provide some more details. Sales increased by 20% to over \$97 million. This is all organic growth. Our Hydraulics segment grew 16% and Electronics grew 28%. If we had not experienced supply chain constraints, our hydraulic growth would have been higher. I'll touch on that further in a moment.

For the quarter, we recorded net income of \$11.9 million. After excluding adjusted items that Tricia will review with you, our non-GAAP net income was \$13.6 million, an 18% increase. Our Adjusted EBITDA grew to over \$23 million, representing a 24% margin. Again, these results were impacted by supply chain constraints due to strong demand for our products and services.



As you know, in late January and early February, we accessed the equity capital market and successfully raised about \$240 million net, so you see those proceeds and additional shares flowing into our first quarter.

In mid-February, we also announced that we signed a definitive agreement to acquire the Faster Group. That acquisition closed in early April. All of our first quarter results do not yet include Faster. We used the proceeds of the equity offering, existing cash and funds from our amended credit facility to fund that acquisition.

As a reminder, Faster Group is a global leader of quick-release hydraulic couplings solutions, complementing our existing hydraulic cartridge valves and manifolds very well. It is a very strategic and transformational acquisition, moving us further along our Vision 2025. Headquartered outside Milan, Italy, Faster brings some very important end markets to us, particularly the global agricultural market, which is entering a growth cycle. Similar to Sun, Faster Group is known for its high quality, high performance products and excellent customer service. The Faster brand is number one in Europe and number two globally. These differentiating factors are driving Faster to gain market share, growing ahead of macroeconomic trends.

We have already begun our integration activities. Last week, we held our first working session amongst the sales teams from our existing CVT and Electronics businesses, along with the Faster colleagues. There's a lot of excitement surrounding the synergy opportunity.

To include the Faster Group in financial results for the remainder of the year, we have updated our 2018 guidance, which includes increasing our revenue range and maintaining our adjusted operating margin range. I will address this further at the end of the presentation.

Please turn to Slide 4 and I will update you on some of our strategic activities in the 2018 First Quarter. First, our investments to drive organic sales are ongoing. These include expanding our application specialists in the field to support customer interaction and penetrate white space where we have historically been underrepresented. For example, we are adding engineering and sales talent in India and are in the process of adding channel partners and application specialists in Southeast Asia and Latin America.

Additionally, our new product development teams are aggressively solving problems and helping customers to create business opportunities, both driving our organic growth. Within our Hydraulics segment, this includes development of the next two phases of our FLeX product offerings. Recall that we introduced Phase 1 in Q4 2017 and now we are working to launch Phases 2 and 3 of this important product program over the next several quarters. These new products are designed to outperform comparable valves in the market and augment our electro-hydraulic product offering, which is the fastest growing sector within the hydraulic cartridge valve market. The Sun FLeX represents our largest new product launch in nearly a decade and is opening up new applications and markets for us.

Within our Electronics segment, we drive growth in new product development with our Vehicle Technologies customers. We then standardize these new products for distribution through our Power Controls business.

On the operations side, we have been working very diligently on our LEAN enterprise initiative to improve our processes, which will in turn drive profitability and increase capacity. Accordingly, we have begun the process to consolidate the CVT manufacturing currently housed in our three Sarasota facilities into two. We expect consolidation of the facilities to be completed in early 2019. This will improve the manufacturing flow in alignment with LEAN principles and, additionally, free up the first facility to become our global CVT engineering and R&D hub. We will be upgrading our testing lab, enhancing flexibility to support our new product development activities. The project to



upgrade the lab will be ongoing throughout 2019, with completion currently expected by the end of that year.

As I mentioned a moment ago, our Hydraulics segment first quarter results were pressured by supply chain constraints since our customer demand was so strong. To alleviate this issue, we negotiated long-term agreements with our largest CVT component suppliers. These agreements address capacity, on-time delivery and quality, as well as pricing. We are already seeing improvements in on-time delivery, which lead to more efficient flow on our production floor as well as support our best-in-industry lead times.

With respect to our Enovation Controls synergies, recall that our target is \$5 million of EBITDA annually, beginning in 2020. We have already completed the cost synergies ahead of schedule and, as of 2018, we have begun realizing the annual savings from merging our HCT activities, formerly in California, into Enovation Controls in Oklahoma. The cost savings are included in our 2018 guidance. The remaining synergies will be realized from sales activities, which are well underway and on track with our original projection.

Next, the construction of our new facility in South Korea continues on plan. We expect commencement of our manufacturing, engineering, sales and warehousing activity at the new location in the third quarter of this year. We look forward to having it up and running to support the significant growth we are realizing in the Asia-Pacific region, in alignment with our in-the-region, for-the-region initiative. Finally, we have completed the roadmap for post-merger integration of Faster Group, which will remain a standalone business. We have identified designated areas of focused, joint activity with CVT and Electronics. This is the same approach we took with the successful integration of Enovation Controls. All of these activities are in pursuit of our Vision 2025 goal, which includes establishing critical mass at \$1 billion in revenue while maintaining superior profitability and financial strength.

With that overview, I will now turn the call over to Tricia to review the financial results for the quarter in a bit more detail.

**Tricia L. Fulton:** Thank you, Wolfgang, and good morning, everyone. Let's begin on Slide 6 with the review of our first quarter consolidated results. First quarter sales were \$97 million, up 20% compared with last year's quarter. This is all organic growth. Most of our products did not have any price increases. The pricing had an immaterial impact on the comparability. Foreign currency translation had a favorable \$2.4 million impact for the quarter, so the growth, excluding the impact of currency, is 16.6%. I will now touch on sales by region, which are designated here in the sales bar chart. There is a table in the back of the press release, as well as the supplemental slides, summarizing this information. As we've previously noted, all geographic markets realized considerable year-over-year growth.

In the Americas, sales were up 19% over the first quarter of 2017 to \$56.5 million, resulting in sales to the Americas market of 58% of the consolidated total. EMEA realized 11% growth to \$22.3 million and APAC region was up 32% to \$18.5 million. As you know, we've made investments in sales and marketing, including additional sales application specialists in the field, and introduced new products, which we believe are driving market share gains that are in excess of economic market expansion.

Regarding profitability, our consolidated Adjusted EBITDA was up slightly over last year's first quarter to \$23.3 million, or 24% of sales. The comparison was impacted by our gross margin results. I'll get into this more as we review the segment results on upcoming slides. But, at a high level, our gross margin was pressured by supply chain constraints, higher material costs and certain operational costs, including some of those that began in the fourth quarter of 2017.



Turning to the bottom line, adjusted earnings per share were \$0.46, up 6% over last year's first quarter. I want to point out that our adjusted net income was up 18%, but our average shares outstanding increased during the quarter due to our secondary offering, impacting our earnings on a per share basis. I also want to remind you that our number of shares outstanding as of April 26, 2018 was about 31.6 million.

I'd like to bring to your attention a few items that impacted our consolidated results and that we added back for purposes of reporting Adjusted EBITDA and adjusted EPS, shown here. Please refer to the tables in the back of the press release or slides for reconciliations of GAAP to non-GAAP numbers.

During the first quarter of 2018, we incurred the following:

- First, \$1.2 million in costs related to acquiring and financing Faster Group.
- Next, we incurred about \$111,000 in restructuring charges associated with a legal reorganization in conjunction with the Faster acquisition.
- Next, we realized a \$505,000 charge on the foreign currency forward contract that we entered into when we signed the agreement to acquire Faster to lock in the euro exchange rate.
- Finally, we recorded a \$402,000 charge associated with interest on the change in fair value of contingent consideration associated with the Enovation Controls acquisition.

During the first quarter of 2017, we incurred the following costs, which we added back for non-GAAP purposes:

- We recorded a \$1.8 million charge for the amortization of an inventory valuation adjustment associated with the Enovation Controls acquisition
- We had \$200,000 of costs related to acquiring Enovation Controls.

Please turn to Slide 7 for review of our Hydraulics segment operating results. Sales grew 16% to \$63 million, with particular strength in the APAC region, continuing the trend we saw last year. We saw 35% year-over-year growth for the quarter in the APAC region, 15% growth in EMEA and 7% growth in the Americas region. The growth was driven by our increased market penetration and new products, as well as broad economic market expansion. Gross profit increased by 6% to \$23 million on the higher sales. The gross margin declined by 340 basis points to 37.5%. We will reconcile that change in detail on the next slide.

Operating income declined 2% to \$13.4 million or 21.5% operating margin. In addition to the gross margin pressures, our selling, engineering and administrative expenses, or SEA, grew \$1.6 million, or 19%, to \$9.9 million compared with \$8.3 million in the first quarter of the prior year. This reflects planned increases in sales and marketing and R&D initiatives as well as professional fees for operational improvements and administrative infrastructure to support our growing organization.

Please turn to Slide 8 and I will reconcile the change in gross profit from the first quarter of 2017 to the first quarter of 2018 for the Hydraulics segment.

Gross profit in the 2017 first quarter was \$22.1 million or 40.9% of sales:

- After adjusting for higher volume, we determined that we incurred \$194,000 or 0.3 percentage points of margin for incremental freight costs due to significant customer demand, similar to that which started in the fourth quarter of 2017. Incremental freight costs improved from Q4 and will further improve in Q2 of 2018.



- Increases in material costs were about \$515,000 or 0.8 percentage points of margin. Recall that we do have a price increase effective July 1 to start covering these cost increases.
- Interim labor costs were a premium we paid for experienced third party contract labor that was isolated to the first quarter, again, to try to keep up with demand and maintain our best in industry lead time. These amounted to about \$461,000 in the first quarter of 2018 or 0.7 percentage points of margin. We have already discontinued the use of this type of labor, so these costs will not repeat in the second quarter.
- We calculated that supply chain constraints and resulting inefficiencies amounted to about \$825,000 or 1.3 percentage points of margin. This includes costs associated with temporary labor and overtime, as well as some inventory adjustments. As Wolfgang mentioned, the long term supply contracts we entered into during the quarter are already starting to reap benefits as we are seeing improved deliveries from our suppliers, which has had a positive impact on our efficiency.
- Finally, we did realize favorable currency effect of \$503,000 or 0.8 percentage points of margin during the quarter, primarily due to the weaker U.S. dollar.

The logistics, material costs, interim labor, production efficiencies and offsetting foreign currency, in total, impacted our 2018 first quarter gross margin by 230 basis points. There were other normal fluctuations, such as varying sales incentives and mix, that offset the leverage realized on the incremental sales.

As we look forward to the second quarter, we are already seeing some improvement but some of these types of cost will continue. The interim labor cost isolated here will not continue in the future period. The logistics and material cost, as well as production inefficiencies, will gradually reduce throughout the year, but will not go to zero because of inflationary impact. All in all, for our organic business, we estimate that about half of the margin impact that we realized in the first quarter will continue in the second and third quarters. We expect the margin impact to be cut in half again in the fourth quarter.

The CVT price increase will take effect on July 1 and, given the timing of the increase at mid-year, we expect to realize approximately 1.5% to 2% additional net sales in Q3 and Q4 as a result.

Please turn to Slide 9 for review of our Electronics segment operating results. Revenue for the first quarter grew 28% over the first quarter of last year, to nearly \$35 million. This was driven by ongoing increased demand in power control and recreational end markets. In addition, proactive sales initiatives and increased demand for new products developed in the past year also contributed to growth.

Gross profit for the segment increased 14% to \$14.2 million, yielding a gross margin of 40.8% compared with 45.7% in the first quarter of 2017. I will reconcile that change in detail on the next slide. Operating income in the first quarter grew 14% over the first quarter of 2017 to \$7.1 million with an operating margin of 20.5%. SEA expenses grew \$900,000, reflecting planned investments in selling and marketing initiatives as well as R&D to support our growth strategy, partially offset by cost savings from consolidating our HCT business into Enovation Controls.

Please turn to Slide 10 and I will reconcile the change in gross profit from the first quarter of 2017 to the first quarter of 2018 for the Electronics segment.

Gross profit in the 2017 first quarter was \$12.4 million or 45.7% of sales.

- Similar to the Hydraulics segment, after adjusting for higher volume, we determined that we incurred \$170,000 or 0.5 percentage points of margin for incremental freight costs due to





significant customer demand. The incremental freight costs are continuing to improve in Q2 of 2018 as supplier delivery performance is improving.

- Also, after adjusting for higher volume, we incurred over \$1.9 million of higher material costs or 5.5 percentage points of margin. The majority of these higher costs, approximately \$1.5 million, were due to product mix with higher electronic content versus mechanical content, which are generally higher in cost, and sales rebates at the higher volumes. We have been in active negotiations with these suppliers to secure steady supply and competitive pricing going forward. We also incurred about \$200,000 of higher than normal scrap, about half of what we realized in the fourth quarter of 2017, and in line with our expectations.
- Finally, we calculated approximately \$760,000 of favorable costs due to improved efficiency as last year we were in the midst of the carve-out process.

The net effect of these three items impacted our 2018 first quarter gross margins by 380 basis points. There were other normal fluctuations, such as varying sales royalties and mix, that offset the leverage realized on the incremental sales.

As we look forward to the second quarter, we are already seeing some improvement, but some of these types of costs will continue. We expect that about half of the margin impact that we realized in the first quarter will continue in each of the remaining quarters of 2018.

Please turn to Slide 11 for review of our cash flow and capital structure. This view is as of March 31, 2018, before financing the Faster Group acquisition, which occurred on April 5, 2018.

In the first quarter, we generated \$14.7 million of cash from operating activities compared with \$12.4 million in 2017, with the 18% increase driven by higher net income. We are pleased that we achieved our target, with 15.1% of operating cash as a percent of our consolidated sales for the quarter.

We finished the quarter with \$199 million of cash. The large cash increase was due to proceeds received from our equity offering, which was done in anticipation of closing on an acquisition target.

Total debt was \$900,000 at March 31, 2018, down from \$116 million at December 31, 2017, upon application of our equity offering proceeds. Following completion of the Faster Group acquisition, net debt is approximately \$340 million and trailing 12 months' Adjusted EBITDA was about \$124 million, representing a 2.7 times multiple. Given the strong cash flow of our combined organization, we believe this is a very manageable level and will aggressively begin repaying it during 2018.

Wolfgang, I'd like to turn it back to you for your perspective on outlook and our updated guidance before we open the lines for Q&A.

**Wolfgang H. Dangel:** Thanks, Tricia. Please turn to Slide 13. The indicators that are important to Sun continue to signal ongoing growth through 2018. For example, U.S. industrial production is expected to continue accelerating growth into the third quarter of 2018, then continue growing in the fourth quarter but at a slower rate. U.S. total manufacturing production and U.S. mining production are currently growing at accelerating rates. All major global economies are in a growth phase, except Mexico. This includes China, Western and Eastern Europe, Canada, India and Brazil. Economies in those regions are also expected to continue growing throughout 2018, but at a slower rate than 2017. Mexico's growth is expected to occur as we progress in 2018.

As our cartridge valves are important to the construction machinery sector, we look to the status of the U.S. construction market. Currently, expansion is expected in most of the sectors in 2018, especially warehouse building construction. Year-over-year growth is anticipated across most of



the manufacturing sector in 2018. Capital goods and North American heavy duty trucks are expected to grow at the fastest rates. Leading indicators point to a mild recession in 2019, with growth expected to resume in 2020.

Finally, the U.S. electronics business indicators continue to point to growth in 2018.

As you have seen, this economic activity is benefiting us, given our current concentrations in material handling and general industrial applications. Important to note, we have stated in accordance with our Vision 2025 plan, we expect to outpace macroeconomic growth. This is being driven by the investments we are making to expand our coverage in the field, increase and broaden relationships with OEMs, penetrate regions where we have white space, and continue to introduce new and innovative products and solutions.

Please turn to Slide 14 for our thoughts regarding our outlook for SNHY. Regarding our organic businesses, strong demand and our backlog gives us confidence in our growth expectations for the remainder of the year, especially visibility for our second and third quarters. From a profitability standpoint, while certain cost pressures will continue into the second quarter, as Tricia mentioned, they are declining as a result of actions we have taken. Further, our CVT price increase, which is the first in three years, will take effect in the beginning of the third quarter and we expect that it will offset the manufacturing cost inflation we have been burdened with. I want to remind you that our investments in our SEA initiatives are necessary and will continue as we are driving top line growth in accordance with our strategy and providing support for our growing organization.

Finally, may I point out that our historic Sun CVT and Enovation Controls businesses are seasonally weakest in the fourth quarter. However, this may not be the case this year for our Sun CVT business, given the demand we have seen from the marketplace.

Regarding Faster, we have included this business in our updated 2018 guidance beginning April 5, when we closed on the acquisition. Prior to our acquisition, Faster experienced 25% growth in the first quarter of 2018 over the prior-year quarter, resulting in about \$40 million of revenue and generating an EBITDA margin of about 28%. Their historical pattern is that the first half of the year is stronger than the second half by a ratio of about 53 to 47. Based on what we see today, we anticipate this will likely be the case in 2018.

Please proceed to Slide 15 where we updated our guidance for 2018. Compared with the guidance we provided in February, which was prior to closing on the Faster acquisition, we are now expecting revenue between \$490 million and \$505 million. This includes between \$107 million and \$112 million for Faster for the remaining three quarters of the year, which will get reported within our Hydraulics segment.

Accordingly, this amounts to consolidated organic revenue growth of 12% to 15%. We expect that revenue for our organic Hydraulics business will grow between 13% and 15%, and revenue for our Electronics business will grow between 9% and 13%. We are currently maintaining our consolidated adjusted operating margin at 22.7% to 24% following our current reporting methodology, which excludes acquisition-related amortization of intangibles and will exclude an inventory step-up adjustment for Faster Group in the second quarter. We believe this range incorporates the gross margin pressures that we discussed earlier, and exhibits our commitment to superior profitability in comparison with other diversified industrial companies. Our interest expense guidance, as shown here, reflects the financing of the Faster acquisition. Our effective tax rate estimate is unchanged. Finally, we have increased our capital expenditures, depreciation and amortization guidance to include Faster and the impact of purchase accounting based on our latest valuation report.

With that, let's open up the lines for questions and answers.



**Operator:** Thank you. At this time, we will be conducting a question-and-answer session. For all audio participants, if you would like to ask a question, please press star, one on your telephone keypad. A confirmation tone will indicate your line is now in the question queue. You may press star, two if you would like to remove your question from the queue. For participants using speaker equipment, it may be necessary to pick up your headset before pressing the star key. Kindly note that those attending via the live webcast, you may also have the capability to submit your questions online and we will take them at the end of the phone questions. One moment for the first question, please.

The first question comes from the line of Brian Drab with William Blair. Please go ahead.

**Brian Drab:** Good morning. Thanks for taking my question.

**Tricia Fulton:** Good morning.

**Wolfgang Dangel:** Good morning, Brian.

**Brian Drab:** The first question, just to be clear on the guidance, \$120 million raised at the midpoint, is that exclusively due to the Faster acquisition or is there any change in the core business outlook?

**Tricia Fulton:** We did have an increase in the core business outlook for Hydraulics. There was a small increase on the Electronics side, but specifically to the Hydraulics segment, it includes Faster plus a small organic increase for the traditional business.

**Brian Drab:** Okay, thanks. Then, Tricia, I think you've put a lot of great detail in the slides around the gross margin dynamic. Can you summarize, again, the pressure quantified in basis points that you saw in the quarter and give us, again, the improvement that you're expecting? If you had pressure of X basis points in the first quarter for the segment, you said it would get reduced by 50% and then 50% again. Can you give us what that impact was in the first quarter and then those ratios again for the period?

**Tricia Fulton:** Yes. For the Hydraulics segment, it was 230 basis points of additional cost in the bridge. If you take all of the items in the bridge for Q1, we expect in Q2 and Q3 to have half of that total, and then in Q4 to have half of that again on the Hydraulics side. On the Electronics side, the items in the bridge are about 380 basis points. If you take all the items in the bridge, we expect to have about half of those flow through into Q2, Q3 and Q4.

**Brian Drab:** Okay, got it. Thank you. Then, last one. In EMEA, you had 11% growth on a consolidated basis. What was the FX impact there, and what was the growth excluding FX? It seems to be relatively slower growth among your geographies. Is there anything to discuss in more detail in Europe and could that re-accelerate?

**Tricia Fulton:** Almost all of the FX effects that we quoted, the \$2.4 million in the quarter, was the result of a weaker dollar to the euro and to the pound. We are seeing almost all of that effect in Europe, which does reduce that 11%, if you're looking at the base currencies there.

**Brian Drab:** Am I wrong to think that that growth in Europe was a little bit weaker than some of the other geographies, or should I just consider that still solid growth even on an organic basis?

**Wolfgang Dangel:** We would consider that, Brian, to still be very solid growth. Obviously, not as exceptional as we see it in Asia-Pacific, but based on benchmarks and comparisons, it's still very solid growth in EMEA.

**Brian Drab:** Nothing competitively or end market wise to highlight that it's unusual or different in Europe at the moment?





**Wolfgang Dangel:** Nothing to highlight at this stage.

**Brian Drab:** Okay. Thanks for taking my questions.

**Operator:** The next question comes from Charley Brady with SunTrust Robinson Humphrey. Please go ahead.

**Charley Brady:** Hi, thanks. Good morning.

**Wolfgang Dangel:** Good morning, Charley.

**Charley Brady:** It sounds as though there's no price increase going on in Electronics, and I'm just curious, what's the reason behind that? Is it just a function of the market dynamics not allowing for it? Also, I want to understand a little better the mix issue on Electronics that impacted the margin in the quarter.

**Wolfgang Dangel:** Yes. First of all, Charley, on the Electronics side, of course, a higher degree of business is tied to OEM than to distribution. It is much more difficult to pass on any price increases there. That's the main reason. Then, to your second question, if we just look at it from an internal commodity perspective, what is mechanical and what is electronics, we are seeing an ongoing shift towards electronic components, but that's nothing new. It's just ongoing and in line with observations we had been making already last year as well.

**Charley Brady:** Okay, thanks. That's helpful. Then, can you comment a little bit more on the applications specialists that you've added - where you are today and where you're expecting to get that to by year end?

**Wolfgang Dangel:** Yes. We added specialists at the beginning of the year, particularly in India. As we pointed out earlier on, we are in the process of adding people in Southeast Asia and in Latin America. That's the application specialists, but we always tried to do that in conjunction, Charley, with appointing open channel partners. As we have pointed out on numerous occasions, we have these white spots in those designated geographies just mentioned and we want to have better coverage. With regard to the second question, we will be cautiously adding some more people in some of those white spots, but probably in consideration of the SEA expenses and development, we want to do that in a cautious manner.

**Charley Brady:** Understood on that. Then, just a final one from me. You talked a little bit about the Faster growth rate in Q1 and that's helpful to get that color and the seasonality there. When you made the announcement about acquiring the company, I think it's expected annualized growth rate on an all-in basis was 16%, 16.5%. Is that still your expectation for Faster on a full year basis?

**Tricia Fulton:** Yes. We are still in that range on a full year basis. In our formal guidance, we widened that range, indicating \$107 to \$112 million, so if you factor in the first quarter of \$40 million, that gets to a range of about 13% to 17%. So, yes, we are still at about that range previously provided of 16% to 16.5%.

**Charley Brady:** Thank you.

**Operator:** The next question comes from Jeff Hammond with KeyBanc. Please proceed with your question.

**Jeff Hammond:** Good morning.

**Wolfgang Dangel:** Good morning, Jeff.

**Jeff Hammond:** I appreciate all of the color, Tricia, on the bridge and each of the segments and the improvements. Can you just talk about, from your perspective, what are the big risks that these costs linger on, or they do not improve to the extent expected, or they push into 2019? Thanks.



**Tricia Fulton:** Yes. The biggest pressures come from improving the efficiencies and being able to ramp up production to cover the levels of demand that we are seeing. We are certainly working on that very diligently, but it is probably a little bit slower process than any of us would like. You cannot really complain about the demand levels that we are seeing, but there are some inherent issues that come along with those. Bringing the suppliers online with the agreements that we have, and also helping them do their planning to make sure we are getting efficient flow of material is critical in both segments.

**Wolfgang Dangel:** I think, Tricia, there might be one additional risk factor to answer your question very specifically. If demand were to further increase, that would put additional pressure on the system. That could be a risk as well. Right now, as we pointed out, we do not see that, but that could be a risk factor there. It is a potential risk.

**Operator:** The next question comes from Mig Dobre with Robert Baird. Please proceed with your question.

**Mig Dobre:** Thank you. Good morning, everyone.

**Tricia Fulton:** Good morning, Mig.

**Mig Dobre:** I want to go back to the discussion surrounding gross margin. I'm trying to do the math here to try to incorporate your guidance and see how the year would flow through, and I'm not quick enough, so I'm asking for some help. Tricia, when you're looking at the gross margin for the full year 2018 in both Electronics and Hydraulics, how were you thinking for the full year? What's embedded in your guide for each segment?

**Tricia Fulton:** We do not guide specifically to gross margin percentages. That's why we've guided to the operating margins and tried to give some color around the gross profit changes that we are seeing from these costs coming in.

**Mig Dobre:** Right. Well, so, here's the challenge that I have. When I'm looking at your commentary that, basically, has some of these inefficiencies enacting drag beyond Q2 in both segments, it looks to me like gross margins could be flat to maybe potentially down for the full year. If that's correct, given what's going on with your SG&A type expenses, I'm having a bit of a hard time understanding exactly how we get to higher incremental operating margins as the year progresses to be able to get your operating margin guidance. My initial assumption was that the inefficiencies were going to go away in the back half of the year, but apparently, they're not. I'm really trying to understand how you got to your numbers for the full year on operating margin guidance.

**Tricia Fulton:** Yes. I can say that, based on where we ended Q1 from a gross margin perspective, we are forecasting to be up from that for the full year. But again, we are not going to guide to a number on that, specifically.

**Mig Dobre:** Okay. But, in the back half, you're going to be up gross margin-wise year-over-year versus the prior year in both segments, is that fair to say?

**Tricia Fulton:** I would say Q2 and Q3 probably are where you're going to see maybe a bit higher margins, because of the revenue expectations from both segments in Q2 and Q3. As you might recall, Q4 is seasonally a lower quarter for the Electronics business, so we do see margin pressures in Q4 as well as what most people see around holidays. I would say, from a flow perspective, Q2 and Q3, given the increased revenue, would probably see the increases over Q1.

**Mig Dobre:** Okay. In Electronics, though, and I'm sorry to keep beating this dead horse, but I remember that, in 4Q '17 in Electronics, we had an unusually low gross margin. It's fair to say that with the incremental volume, even though seasonally things are the way they are, we should be looking at a pretty substantial increase in gross margin on a year-over-year basis in Electronics.



**Tricia Fulton:** Yes, that's a fair statement.

**Wolfgang Dangel:** Year-over-year, that's correct, Mig. If you compare Q4 '18 with Q4 '17 for Electronics, that's correct.

**Mig Dobre:** Correct. What you're saying is, sequentially, gross margins are going to be down in the fourth quarter, but it will be up substantially year-over-year. Okay.

**Tricia Fulton:** Correct.

**Wolfgang Dangel:** That's right.

**Mig Dobre:** Okay. I want to talk a little bit about pricing. You talked about a price increase and it seems like you've taken a bit of a different approach, especially in Hydraulics, with how you deal with pricing versus what I knew from years prior. What is your approach on this price increase? Is this, basically, going to be offsetting material cost and all of these other headwinds that you described here as we look into '19? Is that the idea, or is this supposed to be a source of potential margin upside into '19, the way pricing used to be done traditionally?

**Wolfgang Dangel:** We were just looking at 2018 and, basically, with the introduction of the price increase on July 1, Mig, as we outlined earlier, that will compensate for the inflationary pressures that we see. That will compensate for 2018, in Q3 and Q4. I think we also have to be careful here, and we do not want to make any assumptions for 2019 at this stage, because we do not know how commodity pricing will develop at this stage. We are seeing different trends here. If you look at the latest situation in oil and gas, that could heavily influence it again. The price increase, to answer your question, will cover the inflationary pressure we see in operation for Q3 and Q4.

**Mig Dobre:** Okay, understood. Before I get back in the queue, on your outlook, Wolfgang, you spoke about weaker U.S. manufacturing, potentially into 2019. I get that this is an outlook comment, but I'm wondering what your thinking is behind that. Depending on the way you define manufacturing, I'm wondering what the related impact on Sun Hydraulics could potentially be in 2019.

**Wolfgang Dangel:** Yes. Basically, what I'm looking at is, first of all, industrial production; and then, I'm looking at some of the more specific end markets that we serve, U.S. construction machinery, industrial machinery and such. If I look at the latest economic trend analysis there, we see a softening in 2019. That's where the statement is derived.

How this will impact us? I think, in the meantime, we are much more diversified than we were three or four years ago. I feel more comfortable, because we are serving much more end markets than the industrial sector. But nevertheless, if this became true, it would have an impact on revenue in 2019, resulting out of the construction machinery market and anything else that is tied to industrial production. With regard to industrial production, Mig, we do not see that only in the U.S. I think the industrial production numbers will go down for Canada, Brazil, Western Europe and Eastern Europe for next year, at least based on the trend analysis and the information we have on hand.

**Mig Dobre:** Okay, I understand. I'll squeeze one more here. With that in mind, now that the business is maybe a lot different than it was in prior cycles, how do you think about some of the things that you can do, and are within your control, in order to manage costs in an environment where your forecast plays out into '19 and demand is maybe a little bit weaker?

**Wolfgang Dangel:** I think we still have tremendous flexibility here in the system. Also, as you know, compared with the past, we now have a portion of the workforce that is temporary, so that creates some certain flexibility. As I pointed out earlier on the one question about adding additional application specialists in the field, we'll probably be a little bit more cautious, keeping an eye on developments towards 2019, probably a little bit more cautious in terms of hiring. Having said all that, I think we still have to pay attention to certain geographies that are still booming, and where



we are still creating tons of opportunities, last but not least, in the Asia-Pacific region. We want to be very selective in the approach we are taking. But to answer your question, I think we have flexibility in the system to hunker down and prepare for a softening early enough, without threatening our competencies, because we want to hold on to the core competencies we have in the Company, that we have been building up successfully over the last years.

**Mig Dobre:** Great. Understood. Thank you.

**Wolfgang Dangel:** Thanks, Mig.

**Operator:** The next question comes from Nathan Jones with Stifel. Please proceed with your question.

**Nathan Jones:** Good morning, everyone.

**Wolfgang Dangel:** Good morning.

**Nathan Jones:** I think ITR have been predicting a recession in 2019 for about the last five years, so I suppose they'll be right eventually. I'm going to go back to the Hydraulics gross margin and come at this a little bit of a different way here. Outside of currency, you have headwinds here that were 310 basis points in the quarter. Now, I would imagine the currency impact is going to lessen as we go on, assuming flat rates, that one's a little bit up for grabs. If you say you're going to have half the headwind in 2Q with no price increases, then you'll have half the headwind in 2Q. If you have half the headwind in 3Q with 150 to 200 basis points of price increase, wouldn't that then get you to a positive comparison, just on those headwinds and tailwinds in the third quarter, before you have volume, mix, sales incentives, and then that would be even more positive in the fourth quarter year-over-year if you halve those headwinds again?

**Tricia Fulton:** That could be. In looking specifically at the costs that we have in the bridge, those are the things that we are trying to estimate and control and give the guidance on. Regarding the price increase in Q3, in the first quarter of a price increase, there is always a little bit of a roll-through period, because any orders that are placed ahead of that are still at the old pricing. We are trying to make sure we understand that effect in the third quarter. We'll probably see a little bit more of that pricing effect in the fourth quarter than in the third quarter. But yes, you're right. You're also right that the FX will lessen, because the comps change as we work through the quarters.

**Nathan Jones:** Maybe a little more uncertain on whether it's positive or negative in the third quarter, but should be positive by the fourth quarter then.

**Tricia Fulton:** When you say positive, what do you mean?

**Nathan Jones:** Positive on price versus those drags on margins, with price compensating for what you're looking at there.

**Tricia Fulton:** Yes, that's a fair statement.

**Nathan Jones:** Could you give us a little more color on the supply chain inefficiencies in both segments. It sounds like you've largely taken care of a lot of that in Hydraulics, but maybe not so much in Electronics at this point. Can you talk about what the supply chain constraints are? How you've negotiated with suppliers to, I guess, get to the front of the line to make sure that you have a reliable source of supply there? Just any color you can give us on the supply chain constraints.

**Wolfgang Dangel:** Yes, sure. Nathan, first of all, if you look at the electronics industry and such, we see very strong growth for printed circuit boards. We still see continuous growth for the electronic manufacturing services and in the semiconductor industry. Obviously, those trends are heavily influencing, so we see commodity price increases there with some of the key suppliers for ceramic capacitors, resistors, silicon chips and so forth. That is creeping into the system. As I



mentioned earlier on, as a reply to a previous question, as we do the majority of the business with OEMs, we are embedded into firm pricing arrangements over a certain period of time, so we have no opportunity to pass on these commodity price increases to the customer base. Having said all that, we are negotiating on an ongoing basis with our suppliers in order to secure, first of all, steady supply, because in this type of booming environment it's not always guaranteed that supply is adequate. We are negotiating steady supply as well as competitive pricing, so that we have more planning security as far as that is concerned.

**Nathan Jones:** Do you anticipate having any disruptions in the supply chain that could cause problems? I guess, it's particularly in the Electronics segment at the moment into Q2. Did it impact your revenue at all in 1Q, not having reliable supply the whole time?

**Wolfgang Dangel:** No. I mean, it's just pressure, right? But it's more internal issues of absorbing the growth. As we pointed out, the Electronics business grew 22% again in Q1, over Q1 last year. We have seen tremendous growth here again, up to 33% growth all of last year. But to answer your question, no, that's not the issue, but there is just pressure in the system, obviously.

**Nathan Jones:** Okay. Thanks for taking my questions.

**Wolfgang Dangel:** Sure, Nathan.

**Operator:** The next question comes from Joe Mondillo with Sidoti & Co. Please go ahead.

**Joe Mondillo:** Good morning, everyone.

**Wolfgang Dangel:** Hi, Joe.

**Joe Mondillo:** I also wanted to follow up on the pricing situation. A lot of companies are starting to see more headwinds in the second quarter, as raw material prices increase. I'm just wondering how, or why, that does not become a little bit more of a headwind in the second quarter, considering the price increases in July compared with the first quarter?

**Wolfgang Dangel:** We do not see additional headwind in the second quarter. I think we have been in the brunt of headwind already in Q1, Joe.

**Joe Mondillo:** Okay. All these raw materials have been continuing to rise, why do you say that?

**Wolfgang Dangel:** Well, because, a portion of these prices were already passed on; and then, we have negotiated, as we pointed out, long-term agreements on the Hydraulics side of these with our suppliers that pretty much locked in pricing, so we have a guarantee in place there. That's why we do not see additional headwind in Q2 or Q3.

**Joe Mondillo:** Okay. The SG&A growth investments, in terms of the 1Q run rate, you sounded a little more cautious on applications specialists, and I am wondering if that's going to be stable throughout the year and looking into 2019? Does any of that SG&A investment fall off? I'm guessing no, but I was just wondering, relative to the 1Q run rate, where we are in terms of that?

**Tricia Fulton:** Even though we are being cautious, we are still making investments where we know it makes sense. Because of those investments, we will see some run rate increase on the SEA line.

**Joe Mondillo:** That increases in the second quarter and maybe plateau's in the back half of the year or is that going to continue to increase into 2019?

**Tricia Fulton:** I think it will gradually increase, because of the approach that we are taking. It's not going to be a big lump sum applied, but certainly, we could see some creep up there just because we are trying to make sure we are prepared for the growth that we need in all of the regions as we work towards Vision 2025.





**Joe Mondillo:** Okay. The low end of the Faster revenue guide seems a bit conservative, relative to the growth that you saw in the first quarter. It seems like the first quarter was maybe pretty strong relative to expectations. I was just wondering about that low end of the Faster guidance. Is that a conservative guide and maybe there's upside? Your thoughts on that?

**Tricia Fulton:** Yes. Given the rates that we saw in the first quarter for Faster, it definitely is projecting that their growth rates over last year would slow a little bit as we are going through the quarters. Also, from what we are seeing, maybe a little bit of FX pressure coming as the euro has been declining to the dollar, so we are not trying to outguess the FX market, but are certainly recognizing that there could be some translation impacts in future quarters that we would not have seen in Q1.

**Joe Mondillo:** Okay. Last one for me, could you comment on the timing of some of these Faster synergies? I know Enovation saw a good amount of cost synergies, trends ahead of schedule and you saw those much more upfront, relative to that long-term synergy guidance. I was just wondering how Faster synergies are coming along here in the very early stages?

**Wolfgang Dangel:** Yes. As we said, Joe, we met already for the first time to look at the revenue synergies. We have not taken a look at any cost or expense synergies so far. As you know from our earlier announcement, we want to generate \$7.5 million in EBITDA in 2022 from synergies. But I think it's a fair assessment that we are comparing it to the process with Enovation Controls. We are already further ahead. I mean, let's take into consideration, we just closed on the acquisition four weeks ago and we are already talking about the concrete project on the customer level to generate sales revenue. We are definitely further ahead. I think, to the ramp up curve, you will see, again, out of the \$7.5 million, we estimate 70% will be revenue synergies and the ramp up curve will be pretty linear in between 2019 and 2022. In 2018, we want to basically do the groundwork and then start to see first revenue synergies as early as 2019 and then you can probably ramp it up on a linear basis until 2022.

On the Enovation side, with regard to the synergies, as we pointed out, we have realized the cost synergies already, earlier than originally anticipated. Again, that was about 25% cost synergy, 75% revenue synergy. The 25% are already realized and are already embedded in the guidance here for 2018. With regard to the revenue synergies, I think we are well on the way to meet, or maybe even slightly exceed, the expected synergies by 2020.

**Joe Mondillo:** All right. Thank you. Just one last question. I just want to confirm that the share count that you're looking at for the go-forward is 31.6 million. Is that what you said in the prepared commentary?

**Tricia Fulton:** Yes.

**Joe Mondillo:** Okay. All right, thanks. I appreciate it.

**Tricia Fulton:** Thank you.

**Wolfgang Dangel:** Thanks, Joe.

**Operator:** Ladies and gentlemen, we have reached the end of the question-and-answer session. I would like to turn the call back to Management for any closing remarks. Thank you.

**Wolfgang Dangel:** Thank you for your interest in Sun and for your participation this morning. Also, thank you to all of the hardworking Sun employees who are driving these results. We look forward to updating all of you on our second quarter results in August. Thank you very much and have a great day.

**Operator:** This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.